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Trade Policy Reform in the East Asian Transition Economies

Will Martin

There has been no single magic formula for the success of the East Asian transition economies (Cambodia, China, Lao People's Democratic Republic, and Vietnam), whose performance in export and income growth has been strikingly better than that of transition economies in Eastern Europe and the former Soviet Union. Most of the trade policy problems that remain in these East Asian economies appear to be problems more of development than of transition.

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Summary findings

The performance of the East Asian transition economies in export and income growth has been strikingly better than that of countries in Eastern Europe and the former Soviet Union. The East Asian economies have achieved remarkably high growth rates in outputs and exports without the often large declines in output and exports observed in Eastern Europe and the former Soviet Union.

East Asian reformers have successfully made many of the parallel changes needed in both domestic and trade policies to secure export and income growth. (It makes no sense, for example, to introduce the trade policy instruments of a market economy when the domestic economy is still based on central planning.)

But there has been no single magic formula for their success. Martin discusses what each of the economies (Cambodia, China, Lao People's Democratic Republic, and Vietnam) has done.

China experienced an extended transition process; the transition was much shorter in other East Asian transition economies—especially Cambodia.

Several of the East Asian transition economies used accession to a regional arrangement as part of their reform strategy. China focused mainly on unilateral reforms and, more recently, reforms associated with its accession to the World Trade Organization.

Most have made extensive use of policies to attract foreign investment and to mitigate the burden of protection on manufacturing exporters.

Most of the remaining trade policy problems, although difficult, appear to be problems more of development than of transition.

This paper—a product of Trade, Development Research Group—is part of a larger effort in the group to understand the role of trade reform in successful development and poverty alleviation. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Lili Tabada, room MC3-333, telephone 202-473-6896, fax 202-522-1159, email address ltabada@worldbank.org. Policy Research Working Papers are also posted on the Web at www.worldbank.org/research/workingpapers. The author may be contacted at wmartin1@worldbank.org. January 2001. (37 pages)

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Revised version of a paper presented to the International Conference on *Achieving High Growth: Experience of Transitional Economies in East Asia*, Australian National University, 6-7 September, 2000. Much of this paper draws heavily on work done with Emiko Fukase, who contributed greatly to improving my understanding of trade reforms in the East Asian transition economies.

Trade Policy Reform in the East Asian Transition Economies

Reform of the trading system has been central to the success or failure of reforms in the transition economies of Europe and Asia. In highly successful transition economies such as China and Poland, both trade and output have grown rapidly, with no sustained loss of output during the transition. By contrast, many of the transition economies that suffered greater difficulties during the process have experienced substantial declines in both trade and output.

There are two fundamental reasons for the observed link between trade and overall economic performance. The first is that both depend on the policies and institutions in place in the transition country, and its major trading partners. The second is that increased openness to the world appears to have a strong impact on rates of economic growth (Frankel and Romer 1999). The first source of the observed correlation highlights the importance of reforming trade policy as part of a more comprehensive package of reforms aimed at achieving economic development. The second highlights the importance of reforming trade policies if the reforms are to succeed in raising living standards and alleviating poverty.

Successful reform of the trade regime is difficult, both for technical reasons, and because of the strong political pressures in this sector in all countries. The major technical difficulties in reforming the trading system arise from the need to make these reforms in parallel with reforms in domestic economic policies. It does not make sense, for example, to introduce the trade policy instruments of a market economy in an economy that is still based on a pure planning system. A market-oriented economy relies on price signals to allocate resources, and these price signals are absent, or irrelevant to behavior, in a planned economy. The political difficulties in reforming the trade regime arise in all economies, but particularly in economies, such as most early transition economies, where there is heavy reliance on quantitative controls. These quantitative controls create scarcity rents and the beneficiaries of these rents are frequently strong opponents of further reforms.

While reform is difficult, a great deal can be learned from the experience of those economies which have already made substantial progress with the transition. As we will see, this experience has been extremely diverse. This diversity of experience provides two important lessons. One lesson is that there is no single path to reform. Each country must choose its own path, depending upon its own particular circumstances and constraints. Another is that the path chosen needs to be coherent, and successful in reducing or removing serious distortions or the reform process will not be successful. While mechanisms such as two-tier pricing schemes may play a role in the transition process, they are likely to create considerable problems of corruption and rent-seeking if left in place too long, and should be phased out as quickly as possible.

Some simple numbers on economic performance are examined early in this paper and reveal vastly higher rates of growth in exports and in output in East Asia than in the countries of the former Soviet Union. Explaining this vastly better performance requires examination, not just of trade policy, but of the whole gamut of reforms. However, trade policy reform is likely to be a key element of the picture, and this paper focuses on the reforms made in some of the key East Asian transition economies.

The next section of this paper examines the rationale and need for trade policy reform as part of the transition process. Then, we turn to an examination of the experiences of some of the East Asian transition economies, and comparisons with the experience of Eastern Europe and the Former Soviet Union. After this, we examine the potential role of regional trade agreements and of WTO accession in deepening trade reforms once the transition process is under way. Finally, we consider some lessons for countries beginning the transition process.

The Need for an Open Trade Regime

An open trade regime has at least four major advantages over a closed-economy approach to economic development. These advantages are:

1. The comparative-static benefits from trade
2. The ability of sectors with relatively high productivity to grow far beyond demand in the country itself
3. Dynamic welfare gains arising from continuing rises in productivity
4. Reductions in the incentives for unproductive activities and corruption associated with trade barriers

The comparative-static benefits from trade are the ones most frequently discussed in textbooks in international trade. Perhaps the most fundamental insight of this literature (see, for example, Sodërsten and Reed 1994) is that the gains from trade depend only on a country having a comparative advantage in the production of a good. This means that even a very poor country can gain from trading with other countries. It is simply not the case that a country with poor technology will be unable to compete in the world market[1]. The comparative-static welfare gains from beginning to open up an economy that is closed to participation in world trade are likely to be very large because of the substantial differences in the relative costs of producing goods domestically relative to the costs in other countries. As the country opens up more and more, these welfare gains decline as the differences in cost become smaller.

The second advantage arises because it is difficult to master the technology of production in a new product line. Once these investments in improving technology have been made, as they have been in the clothing sectors of all of the East Asian transition economies, there are potentially very large gains from being able to expand production in high-productivity sectors. In a closed economy, this process of growth is constrained by the size of the domestic market, which is an extremely serious constraint in a small and poor economy. In an open economy, an efficient and expanding industry has the entire world market available to it. Further, in an open, multi-sector economy, it is possible to have extremely high levels of capital accumulation, such as those observed in East Asia, without depressing the return on capital-- as the economy becomes better endowed with

[1] Improving the technology is important, because this will raise incomes.

capital, it shifts into more capital-intensive sectors as suggested by the Rybczynski theorem.

The third advantage is related to the second and, in fact, Bernard and Jensen's results (1999) suggest that most of the productivity gains associated with exporting may be derived from this source. However, there are many other potential sources of productivity gain, including greater ability to upgrade both product and process technology by imitating the approaches used in more advanced trading partners. While much remains unknown about the process by which countries' productivity grows with trade (Edwards 1998) and Dani Ben-David (1996) demonstrate that the ability of poor countries to catch up to the technological leaders is strongly related to the extent to which they are trade partners. Lucas (1988) highlights the way in which these benefits can compound, utterly transforming poor societies within the space of a generation.

The fourth advantage arises from the problems widely observed in developing countries using strong trade barriers, and particularly quantitative barriers, to restrict or eliminate trade. Strong trade barriers can lead to very large distortions, and to the waste of a great deal of resources on pursuing these rents, either legally or illegally (Krueger 1984). The availability of large gains from illegal activity tends to divert resources from productive activities, and to lead to corruption in the administrative and enforcement services whose performance is now recognized as central to successful development (World Bank 1999a).

It is frequently argued that trade policy should have many objectives other than efficiently linking domestic to world markets. These objectives typically include: revenue raising; the protection of infant industries; and environmental and social goals. In most cases, these objectives are likely to be more successfully addressed through instruments better targeted to them.

While tariffs are frequently an important source of revenue in poor countries, it is important to do as much as possible to reduce countries' dependence on these revenues. It is frequently argued that collecting revenues from customs duties at the border is easier and less expensive to than taxing production or consumption. However, this will typically not be the case for the high-revenue items such as alcohol, tobacco and petroleum products, for which domestic production is likely to be very concentrated and easy to tax. Transition economies such as Cambodia have also been able to reduce their reliance on customs duties by introducing modified Value Added Taxes (VATs) on a range of commodities.

The infant industry argument is very old, but has typically been found to be without justification. The basic argument is that there is some market failure, such as an inadequate capital market, a lack of skilled workers, or a need to learn by doing, and that protection is essential for production to get under way. From an economic point of view, it is clear that the best approach to dealing with any of these problems is with a policy response that deals with the underlying problem. From a policy perspective, such "infant" industries have rarely "grown-up", and frequently continue to seek protection well into advanced old-age[2].

The use of trade measures for environmental and social goals should also be approached with caution. Most environmental problems are related not to trade, but to either a production process or the level of consumption. Trade policies measures are inferior to environmental policy measures that can directly attack the environmental problem (Martin 1999). Proposals to use trade measures to improve labor standards are subject to the same criticism.

It is very common for trade regimes to include some degree of tariff escalation, where tariffs are low on raw materials, higher on intermediate products, and higher again on final goods. Such escalation is typically seen as harmless, or even desirable. However, such a system can easily create serious economic distortions. The net impact on producers in a particular sector will include the negative impact of protection on inputs, and the positive impact of protection on outputs, the combined effect of which is

[2] Industries such as steel and clothing in the industrial countries of today provide good examples.

measured using the Effective Rate of Protection (Corden 1997) Clearly, exporters will suffer from such a system because they receive no protection on their output, and must pay the costs of tariffs on their inputs. By contrast, producers for whom protected inputs are a minor source of production, and for whom value added is a small share of output value, may receive very large windfall gains.

For all of the reasons outlined above, most economists strongly favor a trade regime using price-based trade measures such as tariffs that are as low and uniform as possible. Getting to such a trade regime from the trade policies prevailing under a planned economic system involves many inter-related steps, and the experience of earlier transition economies is a potentially very useful guide for future reforms. In the next section, we therefore review the approaches followed by several East Asian transition economies.

Reform Experience in East Asian Transition Economies

Under a classical planned-economy trade regime, trade in each product is monopolized by a foreign trade corporation. Policy measures such as tariffs, quotas, licenses, and exchange rates play a relatively minor role, since most decisions about the level and composition of exports and imports are made through the planning system. Reform of such a system to a more market oriented trading system requires a number of steps, such as:

1. Opening up the trade system to competing traders
2. Developing indirect policy instruments such as tariffs and quotas and moving progressively to price-based measures
3. Removing exchange rate distortions,
4. The possible introduction of measures to reduce the impact of continuing distortions.

These trade reforms must take place in the context of fundamental reforms in the domestic economy. In particular, it is necessary that property rights be defined in a manner that provides sufficient autonomy for managers to respond to market signals rather than, or in addition to, planning mandates. Further, mechanisms must be devised to allow market prices to exist, and to link with world prices through the trade regime.

These adjustments can potentially be made all at once, or they can be phased in. Either approach can work quite well. The transition economies of Central and Eastern Europe followed the former approach, and were rapidly integrated into the world trading system (Michalopoulos 1999). The Royal Government of Cambodia also followed a relatively rapid, and relatively successful, approach to reform. A phased approach has been used, with great success, in China, whose growth in trade and output during the reform era has been extremely rapid. A gradual approach is not without its dangers, however, as is clear from the experience of Russia and some other members of the Former Soviet Union, where the momentum for reform appears to have stalled, with trade and output declining and then, at best, stagnating for an extended period (Michalopoulos 1999).

The study of eight countries created from the Former Soviet Union reported in Michalopoulos and Tarr (1996) provides an important benchmark for the East Asian transition economies. In this study, the Baltic countries, the fastest reformers, had the best trade performance. The moderate reformers such as the Kyrgyz Republic, Moldova and Russia had made significant policy reforms by the mid 1990s, but had not yet arrested the decline in output and trade. The slowest reformers, such as Ukraine, Uzbekistan, Belarus and Georgia, had by far the worst performance.

While any such comparisons are made difficult by data limitations, it seems worthwhile to attempt a simple comparison of the performance of the East Asian transition economies with some of those in Eastern Europe and the Former Soviet Union. To this end, growth rates of exports and of GDP for selected countries are presented in Table 1.

Table 1. Growth rates of exports and of GDP in selected transition economies, 1990-99

	Exports	GDP
	%	%
Belarus	-2.6	-4.3
Cambodia	20.2	4.8
China	17.0	10.7
Lao PDR	21.1	6.4
Latvia	-7.1	-4.8
Mongolia	4.4	0.7
Myanmar	15.4	6.3
Poland	10.6	4.7
Romania	8.7	-1.2
Russian Federation	0.6	-6.1
Ukraine	-1.8	-10.8
Uzbekistan	-9.6	-2.0
Vietnam	28.3	8.1
Average East Asian Transition Economies	18.2	6.1
Ave EA Transition (excl Mongolia)	21.6	7.5
Source: World Development Indicators. Note: Growth rates are exponential. Period 1990-1999 or nearest available. Exports generally BOP basis, in current US dollars. GDP growth in constant local currency.		

From the table, it is clear that the performance of most of the East Asian transition economies has been very strong over the periods during the 1990s for which comparable data are available. The average export growth rate of the East Asian transition economies was 22 percent. Linked with this was an extremely strong growth average GDP growth rate of 7.5 percent. In none of the East Asian economies was there anything resembling the sustained and deep output contractions that have been experienced in the Former Soviet Union. Of the East Asian transition economies, only Mongolia had an anemic growth rate, and even here the average economic growth rate over the period was still slightly positive, at 0.7 percent per year. In the remainder of this paper, we examine the trade reforms that were undertaken in several of the reforming East Asian economies, to provide a basis for understanding whether trade policy reforms might have contributed to this outcome.

Trade Reform experience in China

China's reform experience is important since it was the first of the East Asian transition economies to begin reforms, is well documented, and has provided a model for other transition economies. To understand the reform experience in China, it is useful to review the features of the pre-reform trade regime. After examining this, we turn to the process by which it was reformed.

The Pre-Reform Chinese Trade Regime

The pre-reform Chinese trade regime was dominated by between 10 and 16 Foreign Trade Corporations (FTCs) with effective monopolies in the import and export of their specified ranges of products (Lardy 1991). Planned import volumes were determined by the projected difference between domestic demand and supply for particular goods, with export levels being determined by the planners at levels necessary to finance planned imports.

Under the pre-reform Chinese system, commodity prices were set without regard to scarcity or cost, and were intended to serve only an accounting function. Further, the exchange rate was very substantially overvalued, creating a general disincentive to export and an artificial incentive to import. Many producer goods had low prices that would have made exports artificially profitable and made necessary imports of some needed goods unprofitable. An explicit objective of the Foreign Trade Corporations was to create an air-lock between producers and foreign markets that would vitiate the artificial incentives created by the pricing system [3].

Conventional trade policy instruments such as tariffs, quotas and licenses had a very limited role. Price-based measures such as tariffs were obviously unimportant since the planning system was based on quantity decisions rather than behavioral responses to

[3] Or, in the original conception, to insulate the economy from the harmful irrationalities of world market prices (World Bank 1988).

prices. There was little need for quotas or licenses since the quantities to be imported could be controlled by the relevant monopoly trading corporations. As Lardy (1991) notes, the introduction of licensing actually reflected a liberalization of China's trade regime.

A major World Bank study (1988) of China's foreign trade regime highlighted the many disadvantages and costs of China's pre-reform trade regime, many of the features of which were still present in the mid 1980s. The air-lock between China and the world market was a particular focus of concern because of the resulting lack of information about the needs of export markets, and a lack of competition from imports, both of which generated substantial inefficiencies. The rigid foreign exchange system was another major cause for concern because it created a need for inefficient, bureaucratic allocation of foreign exchange.

Trade Policy Reform in China

Reform of China's trade regime had three major dimensions: increasing the number and type of enterprises eligible to trade in particular commodities; developing the indirect trade policy instruments that were absent or unimportant under the planning system; reducing and ultimately removing the exchange rate distortion. These reforms were inextricably linked to price and enterprise reform within the economy that allowed prices to play a role in guiding resource allocation, and enterprises to respond to these price signals. These reforms of the trading system were inextricably linked with reform of the enterprise sector to replace central planning of outputs with indirect regulation through market-determined prices. These reforms were undertaken incrementally, with feedback from each reform taken into account in designing the next stage of the reform-- an approach colorfully described as "crossing the river by feeling the stones" -- rather than proceeding according to a comprehensive overall plan for reform.

A central feature of the reforms was the decentralization of foreign trade rights beyond the original handful of centrally controlled foreign trade corporations. This was not done according to the usual negative list approach whereby enterprise can trade in any good except those subject to restricted trading rights. Rather, a combination of a negative list for commodities and a positive list for trading firms was introduced. A negative list approach is used to reserve a list of commodities for trading by specified enterprises. Firms wishing to trade in other products are required to be on a positive list of firms with trading rights for those particular goods. The reform process gradually increased both the number of firms allowed to trade, and the number of different types of firms eligible for trading rights.

The number of FTCs with trading rights was progressively expanded, with trading rights provided to branches of the FTCs controlled by the central government, and to those controlled by regions and localities. Since 1984, these trading enterprises have been legally independent economic entities (Kueh 1987) and state owned trading enterprises of this type now appear to operate very strongly along commercial lines (Rozelle *et al* 1996). Joint ventures between domestic and foreign firms, and firms located in the special economic zones were also allowed the right to trade their own products relatively early during the reform process. At a later stage, large producing firms began to gain direct foreign trade rights. The process of decentralizing trade was gradual, but the trend was very consistent, with commodities being progressively removed from export and import planning controls. Indeed, by 1992, these plans covered only a small share of products (World Bank 1994; Yin 1996, p103) and they have since been abolished.

An important feature of the reforms was the introduction of special arrangements for processing trade. The distortions created by tariffs and nontariff barriers in the early phase of reform would have precluded large-scale production of manufactures for export. In response to this problem, imports of intermediate inputs for use in the production of exports were almost completely liberalized, as were capital goods inputs for use in joint ventures with foreign enterprises. Initially, this favorable treatment was extended only to enterprises operating in free trade zones, but coverage of these arrangements was quite rapidly extended. This category of imports came to represent a very large share of total imports, accounting for almost half of total imports by 1996.

Import and export licensing measures were introduced in 1980 to replace the controls imposed under the previous trade monopoly (Lardy 1991). The coverage of licensing was initially small, but increased sharply as more and more trade was removed from the planning process. Lardy (1991, p 44) notes that licensing covered two thirds of China's imports in 1988. Since then, the coverage of licensing has fallen dramatically.

An important transitional device used to reduce, and ultimately remove, the distortions in both commodity prices and exchange rates was the multi-tier pricing system. Under the two-tier pricing system for commodities, the plan price continued to operate for the quantity of the commodity that producers were contracted to supply. However, to stimulate output, producers were allowed to supply additional output at a secondary market price. When plan prices are below market prices, this system can, in the short-run, allow revenue to be generated in a non-distorting manner (Sicular 1988; Byrd 1989). The revenues raised were frequently redistributed to consumers within the same market. This was the case for grains, where consumers were supplied with fixed rations of grain at below-market prices.

A two tier system for foreign exchange involved an overvalued official exchange rate and a higher secondary-market rate. This distorted trade by discouraging both exports and imports (see Martin 1993, World Bank 1994). Over time, the share of foreign exchange receipts that exporters could retain for sale on the secondary market was raised, lowering the gap between the rates received by exporters and paid by importers, and reducing the extent of the distortion. The exchange rate was unified in 1994, removing this distortion.

These two-tier systems were feasible in China because of its ability to compel state-owned enterprises and farming households to continue to delivering outputs at below-market prices. However, the large discrepancies between official and market prices created enormous incentives for corruption that would, if continued, have jeopardized the reform process. These incentives for corruption were reduced by relatively rapid increases in plan prices, reducing the gap between them and market prices.

The importance of market prices relative to plan prices increased very rapidly as the reforms progressed. The share of retail commodities sold at fixed prices declined from 97 percent in 1978 to only 5 percent in 1993. Even for agricultural goods, where state pricing of some basic commodities such as grains remains important, only 10 percent of total sales were at state fixed prices in 1993. However, in a significant reversal of the trend towards liberalization, the share of goods subject to state pricing increased substantially between 1993 and 1995, although this share remained much lower than it had been prior to the early 1990s.

Types and Numbers of Trading Firms

The positive-list system for allocating trading rights in China would potentially allow direct control of imports if the number of trading enterprises were small, and if these enterprises were subject to a single supervisory body. However, The Ministry of Foreign Trade and Economic Co-operation (MOFTEC) reported that roughly 9000 Foreign Trade Corporations were active with very broad trading rights (MOFTEC personal communication, June 1999). Of these around 100 are owned by the central government, and the remainder are owned by provincial and local governments. In addition to these Foreign Trade Corporations, there is a number of other types of firms with trading rights, including joint ventures with foreign firms, foreign firms operating in China, and a small number of private and collective firms.

Naughton (1996) notes that State Owned Enterprises (SOEs) accounted for a relatively large share of the trade subject to ordinary customs duties, as distinct from preferential regimes such as imports for processing). In 1996, ordinary customs trade accounted for only 28 percent of imports (Economic Information and Agency 1997), and SOEs of one form or another accounted for 79 percent of this trade. However, these SOEs include a very wide range of firm types, including: state trading monopolies, FTCs administered by the central government, FTCs administered by provinces and municipalities, SOEs with direct trading rights for their own products, and wholesale and retail trading firms. Except for those cases where there are restrictions on trading rights, the very large numbers of potential importers within and outside the ranks of the SOEs seem likely to create a relatively competitive trading environment. Further, China's accession to the WTO will remove the restrictions on trade, distribution and retail activities.

Despite the large number of trading firms overall, there are two broad groups of commodities for which the number of firms entitled to engage in trade is tightly restricted. One of these groups is subject to state trading, while the other is subject to designated trading. The state trading system applies to a relatively small number of commodities that are believed to be of particular importance for the peoples' livelihood and national economic development—many of these commodities are either agricultural products, or agricultural inputs such as fertilizer. The system of designated trading applies to a range of other important commodities. The 70 tariff lines subject to state trading on the import side are drawn from the commodity groups set out in Table 2, as are the 115 tariff lines covered by state trading on the export side. The 229 tariff lines subject to designated trading are primarily importables.

Table 2.. Products covered by state trading and designated trading.

	Imports	*Exports*
State trading	Grain, vegetable oils, sugar, tobacco, crude oil, refined oil, chemical fertilizer, cotton	Tea, maize, soybeans, tungsten and products, coal, crude oil, refined oil, silk, unbleached silk, cotton and products, antimony
Designated trading	Rubber, timber, plywood, wool, acrylics, steel and products	Rubber, timber, plywood, wool, acrylics, steel and products
Source: Government of China, 2000.		

The products subject to state trading are typically handled by one or a few foreign trade corporations, making direct control of the quantities imported and exported relatively practical. The system of coordination and control used for major state-traded commodities such as grains and fertilizer appears to follow the basic lines used under the traditional planning system. Estimates of the gap between supply and demand are made up to 18 months in advance of the actual trade taking place, and there appears to be considerable reluctance to adjust the quantity targets in responses to developments such as unanticipated shocks to domestic supply or demand. Recent empirical research concludes that, rather than helping to stabilize domestic grain prices, this inflexible system contributes substantially to the volatility of domestic grain prices (World Bank 1997a). Carter, Chen and Rozelle (1998) identified many of the classic features of the traditional monopoly trading system in the grain trade—an "airlock" between buyers and suppliers; poor quality matching; unpredictable timing of deliveries. In addition, they found many of the features of poorly operating markets, particularly concerns that traders are using their superior information to take advantage of buyers in China.

Nontariff barriers

The coverage of state trading and designated trading is shown, together with other nontariff barriers affecting China's import trade, in Table 3. From the table, it appears that state trading and designated trading accounted for 11 and 7 percent respectively of total imports, and made up over half of the total trade coverage of nontariff barriers in China. Clearly, the regime used for state trading and designated trading is an important special feature of the Chinese trade regime, but very much a minority part of the overall system, rather than the dominant part. The heavy reliance on state trading for major agricultural trade has, however, raised concerns about the transparency of China's agricultural trade regime (see Dixit and Josling 1997).

The average protective impact of the complete set of nontariff barriers presented in Table 3 was estimated to be equivalent to a 9.3 percent *ad valorem* tariff (World Bank 1997b). This evaluation was undertaken using information on the tariff equivalents of these nontariff barriers obtained from the Unirule Institute study prepared for the Institute of International Economics (Zhang, Zhang and Wan 1998) and from price comparisons drawn from the International Comparisons Project. Products imported under the State Trading categories accounted for only 0.7 percentage points of this total protection. On this basis, it appears that state trading of imports, the only form of nontariff barrier that will remain when China implements its WTO accession arrangements, has been a very minor restriction on trade in the recent past.

Table 3. Share of imports covered by NTBs in 1996, using 1992 trade weights.

	State	Desig.	Lond.	Licenses	Quota	Tend.	All
Rice	100.0	0.0	0.0	100.0	0.0	0.0	100.0
Wheat	100.0	0.0	0.0	100.0	0.0	0.0	100.0
Coarse grains	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nongrain crops	50.0	22.9	0.0	72.9	72.9	0.0	72.9
Livestock	0.0	72.7	0.0	72.7	72.7	0.0	72.7
Meat and milk	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other food products	37.2	0.0	0.0	32.9	31.7	0.0	38.4
Natural resources	46.6	12.8	0.0	0.0	0.0	0.0	59.5
Textiles	0.3	5.7	0.0	12.7	12.7	0.0	12.7
Wearing apparel	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Light manufactures	0.0	9.3	0.0	0.0	0.0	0.0	9.3
Transport equipment	0.0	0.0	0.0	35.8	35.8	6.6	42.4
Machinery and equipment	0.0	0.0	0.0	9.2	9.2	20.4	26.8
Basic heavy manufactures	18.7	16.2	0.3	23.5	22.7	0.0	37.7
Services	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	11.0	7.3	0.1	18.5	16.3	7.4	32.5

The measures listed include state trading, designated trading, the London Convention, import licenses, import quotas, and price tendering. Source: World Bank 1997b

Tariff barriers in China

The pace of tariff reform begun in the early 1990s has been continued in recent years. A significant tariff reform was implemented in October 1997, reducing average tariffs significantly below 20 percent, while a more limited reform in January 1999 focussed on timber products. Some basic data on trends in average tariff rates are given in Table 4, where simple averages, as well as trade-weighted averages are reported for broad groups of merchandise trade.

In recent years, the reform process in China's trade policy has been heavily influenced by the ongoing negotiations for WTO accession (Ianchovichina, Martin and Fukase 2000). While the final agreement is not yet fully known, it is clear that it will involve further reductions in tariff rates, to a simple average of around 9 percent in manufactures, and around 15 percent in agriculture. All nontariff barriers other than state trading are to be abolished. All tariffs will be subject to WTO tariff bindings that will require tariff reductions. China is also making substantial commitments to open up its trade in services, and will be committing itself to protecting Intellectual Property Rights at the standards specified in the WTO agreement on Trade-Related Intellectual Property Rights (TRIPS). Most of the adjustments required by China's accession will be made by China itself, but the agreement will lead to the phasing out of quotas against China's exports of textiles and apparel, and will provide China with protection against many types of unilateral action by its trading partners.

Table 4. Changes in average tariff rates in China

	All merchandise		*Primary products*		*Manufactures*	
	Simple	*Weighted*	*Simple*	*Weighted*	*Simple*	*Weighted*
	%	%	%	%	%	%
1992	42.9	40.6	36.2	22.3	44.9	46.5
1993	39.9	38.4	33.3	20.9	41.8	44.0
1994	36.3	35.5	32.1	19.6	37.6	40.6
1996	23.6	22.6	25.4	20.0	23.1	23.2
1997	17.6	18.2	17.9	20.0	17.5	17.8
1998	17.5	18.7	17.9	20.0	17.4	18.5
Source: World Bank (1999, p340)						

Trade Reform in Vietnam[4]

The reform era of *doi moi* in Vietnam began in 1986, eight years after the commencement of comprehensive reforms in China. Key events in trade policy and related areas are given in Table 5.

From the table, it is clear that reform in Vietnam proceeded very rapidly in undertaking the multi-dimensional reforms needed to move from a planned trade regime. In 1988, the crucial step of abolishing the central government's monopoly on trade was taken, farming households were given land use rights, the customs tariff was introduced,

[4] This section draws heavily on Fukase and Martin (2000).

and the establishment of private enterprises was officially encouraged. Further major reforms were introduced in 1989, when quotas were removed on all but a few export and import commodities, the coverage and rates of export duties were reduced considerably, the foreign exchange system was unified, and producers allowed to sell to any licensed foreign trade company.

Table 5. Major changes in Vietnam's trade and related policies since the beginning of the reform era

Year	*Changes in trade and exchange system*	*Other reforms*
1986		Party congress declares beginning of *doi moi*
1987	Law on foreign investment—introduction of 'open door' policy	Land Law establishes private use of allocated land in agriculture Law on Foreign investment—introduction of 'open door' policy
1988	Foreign exchange control decree liberalises retention of foreign exchange. Devaluation of trade and invisible payments exchange rates Introduction of a customs tariff	Cooperative method of agriculture production abandoned in favour of households. Encouragement of private enterprises becomes official policy
1989	Quotas removed on all but ten export and 14 import commodities Export commodities subject to export duties reduced from 30 to 12 and most rates reduced Producers of exportables allowed to sell to any appropriately licensed foreign trade company Foreign exchange rate system unified All budgetary export subsidies removed	Nearly all forms of direct subsidization of production and price control removed
1990	General export-import companies required to register with regulatory organization for individual commodities	Law on Private Enterprises establishes legal establishment of sole proprietorships Law on Companies establishes legal basis for operation of independent enterprises
1991	Inputs used to produce exports exempted from duty Private companies allowed to directly engage in international trade	
1992	Foreign investment law amended to reduce discrimination in favor of joint ventures against foreign owned enterprises	Individuals allowed property rights over income producing asset personal property Pilot equitisation program for SOEs introduced

Year	*Changes in trade and exchange system*	*Other reforms*
1994	Vietnam gains GATT observer status Introduction of interbank foreign exchange market Steps in process of licensing to engage in international trade reduced from three to two	
1995	Coverage of export quotas reduced to rice Vietnam joins ASEAN	New regulations on land limits nature of land use rights.
1996	Maximum tariff rate reduced to 80 per cent	Law on State Budget formalises budgetary practice and defines revenue and expenditure responsibilities of different levels of government Law on Minerals lays out framework for exploitation of mineral resources
1997	Imports of sugar prohibited Temporary prohibitions imposed on imports of wide range of consumer goods then lifted	Introduction of VAT in 1999 Law on Cooperatives confirms continued government support for cooperative business
1998	Forward and swap foreign exchange transactions authorized Highest tariff rate reduced to 60 per cent Management of imports of most consumer goods shifted to tariffs rather than quotas or licensing Domestic enterprises authorized to directly export production without an export/import license Amendment to import/export tax law introduces 3- schedule tariff, and provision for antidumping and countervailing duty	Taxpayer identification numbering system introduced

Source: Based on Table 1.3 of CIE (1998).

The pace of reform remained rapid during the early 1990s. A legal basis for independent firms was introduced, private firms were allowed to enter foreign trade; tariff exemptions were introduced for inputs used in the production of exports; the coverage of nontariff barriers was reduced, and considerable progress was made in reforms for foreign investment; and the development of financial and legal institutions.

During this period, the rates of growth of exports were particularly high[5]. During the late 1990s, progress was made in a number of areas, including reductions in maximum import tariff rates, the implementation of tariff reductions associated with membership of the ASEAN Free Trade Area. However, in a number of cases, the reform process appears to have slowed or even been reversed. After 1997, the rate of growth of exports also declined dramatically.

A significant indication of a new approach to reform occurred in 2000, when Vietnam and the United States agreed to a bilateral trade agreement that seems likely to provide Vietnam with MFN access to the US market, and to commit Vietnam to liberalization of its markets for goods, services and investment. Vietnam's offer on merchandise trade is relatively modest, and seems likely to reduce its average import tariff by only around 1 percent. The main gains to Vietnam on merchandise trade liberalization will come from its increased access to the US market (see Fukase and Martin forthcoming). However, its commitments on services are relatively deep and wide ranging, and it has agreed to implement a relatively comprehensive agreement on intellectual property rights. This agreement seems to be another important step in deepening Vietnam's reforms, and helping pave the way for future accession to the WTO.

Vietnam has the objective of converting itself into an industrial country by 2020, and import substitution linked to state control and protection remains an influential idea. Considerable attention has been paid to the development of the industrial base through a combination of export orientation and import substitution. Vietnam appears to be targeting the development of a set of capital-intensive and so-called strategic industries and using trade and investment policies to promote these industries. A problem with this approach is that it has contributed to the emergence of a high and variable set of nominal and effective rates of protection, and hence to considerable distortions.

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[5] Over the 1990 to 1996 period, the average compound growth rate of exports was 31 percent using World Development Indicators data.

Nominal and Effective Rates of Protection

Table 6 shows a summary of Vietnam's tariff protection. The first two columns show the nominal rate of protection (NRP) whereas the second two show the effective rate of protection (ERP). The simple average tariff rate is 15.6 percent and the trade-weighted average is 19.0 percent. There is a general tendency for Vietnam's tariff structure to be relatively low for capital goods and raw materials, and higher for finished goods. This pattern of protection increases the returns to value-adding factors in the final goods industries. Even quite moderate tariffs on final goods can lead to sharp increases in the returns to value added in a particular sector if intermediate inputs are a large share of total costs. Imports of most basic industrial raw materials are relatively free of import restrictions since Vietnam does not yet have significant upstream steel or plastics industries (Flatters, 1998a). For many goods that are not produced in Vietnam, the tariff rates are virtually zero. This confers a great advantage on domestic users of these products.

An indication of the total impact of protection can be obtained using the Effective Rate of Protection (ERP). The ERP differs from the NRP by taking into account the trade barriers that are imposed on the intermediate inputs used in the production of goods.[6] Protection granted to final goods increases returns to value adding factors in a

[6] The effective rate of protection (ERP) is defined as the percentage change in producers' value-added, as a result of taxes on trade, over the level of value-added that would have prevailed in the absence of those taxes. For import substituting industries, the formula for calculating the ERP is

$$ERP_m = (VA_{mj} - VA_j^*)/VA_j^*$$

where VA_{mj} is industry j's value added at domestic prices and VA_j^* is value added at world prices. VA_{mj} and VA_j^* are computed as

$$VA_{mj} = VO_j - \Sigma\, INT_{ij}$$
$$VA_j^* = VO_j/(1 + t_j) - \Sigma\, INT_{ij}/(1+t_i)$$

where VO_j is the value of output of industry j, INT_{ij} is the use of intermediate input i by industry j, and t_j is the nominal tariff rate imposed on industry j. The ERP for export production can be

$$ERP_x=(VA_{xj} - VA_j^*)/VA_j^*$$

where

$$VA_{xj} = VO_j/(1 + t_j) - \Sigma\, INT_{ij}$$
$$VA_j^* = VO_j/(1 + t_j) - \Sigma\, INT_{ij}/(1+t_i)$$

sector. By contrast, taxes on intermediate inputs reduce the returns to value adding factors. Protection has different implications for import substituting and export oriented activities. Higher protection on outputs raises the domestic prices for import competing goods and increases the returns involved in producing them. Exporting activities have to face world prices for their sales and so do not benefit from protection on their output. They can only be harmed by protection to other sectors. The ERP measures provided in this section capture the direct adverse impacts of protection on these firms. There is an additional adverse impact that arises from the increases in the prices of nontraded goods—the real exchange rate appreciation effect of protection.

Table 6. The Structure of Vietnam's Protection

		Nominal Protection of Import Tariff		*Effective Rate of Protection (ERP)*	
GTAP	*Description*	*Simple Average*	*Weighted Average*	*ERP for Import Substitution*	*ERP for Export Production*
		(%)	*(%)*	*(%)*	*(%)*
1	Paddy rice	5.0	5.0	4.2	-3.8
2	Wheat	3.0	3.0	3.0	0.0
3	Cereal grains	5.9	2.6	-4.6	-10.0
4	Vegetables, fruits, nuts	24.3	27.2	41.6	-8.1
5	Oil seeds	8.6	6.5	4.4	-7.1
6	Sugar cane, sugar beet	10.0	10.0	9.7	-3.8
7	Plant-based fibers	3.9	4.2	1.3	-6.0
8	Crops n.e.c.	13.2	6.2	4.5	-5.8
9	Cattle, sheep, goats, horses	4.5	4.8	0.9	-7.1
10	Animal products n.e.c.	5.0	3.7	-1.5	-7.4
12	Wool, silk-worm cocoons	3.0	1.3	-2.2	-4.2
13	Forestry	4.0	1.2	-20.5	-22.9
14	Fishing	16.9	18.9	66.6	-45.7
15	Coal	3.8	3.4	-14.4	-22.2
16	Oil	4.5	1.0	-13.9	-15.9
17	Gas	14.1	15.5	24.5	-13.3
18	Minerals n.e.c.	2.3	1.1	-21.4	-27.0
19	Bovine cattle, sheep,goat meat	12.2	10.3	12.2	-3.5
20	Meat products n.e.c.	18.1	27.3	43.3	-5.4
21	Vegetable oils and fats	13.1	12.3	1.4	-98.5
22	Dairy products	16.7	14.5	16.3	-5.7
23	Processed rice	7.5	7.5	8.0	-22.5
24	Sugar	30.0	30.0	na[a]	na[a]
25	Food products n.e.c.	28.6	20.1	59.6	-48.3
26	Beverage and tobacco	52.1	50.2	Na[a]	na[a]

Value added at domestic prices for export production (VA_{xj}) differs from that for import substitution (VA_{mj}) since exporters face world prices for their sales.

		Nominal Protection of Import Tariff		Effective Rate of Protection (ERP)	
GTAP	Description	Simple Average	Weighted Average	ERP for Import Substitution	ERP for Export Production
		(%)	(%)	(%)	(%)
	products				
27	Textiles	29.4	30.0	115.0	-138.0
28	Wearing apparel	49.2	49.4	229.8	-231.9
29	Leather products	18.8	13.5	-15.1	-67.1
30	Wood products	18.7	11.9	15.2	-19.3
31	Paper products, publishing	20.0	19.4	88.1	-88.5
32	Petroleum, coal products	9.6	44.0	na[a]	na[a]
33	Chemical, rubber, plastic, products	8.8	6.4	-0.1	-40.3
34	Mineral products n.e.c.	20.7	23.8	69.6	-52.3
35	Ferrous metals	5.3	6.0	3.7	-25.3
36	Metals n.e.c.	5.8	10.4	21.9	-103.8
37	Metal products	18.5	16.6	34.5	-33.9
38	Motor vehicles and parts	22.6	18.6	186.4	-200.7
39	Transport equipment n.e.c.	13.2	28.3	56.6	-32.9
40	Electronic equipment	9.7	10.7	13.8	-18.4
41	Machinery and equipment n.e.c.	7.4	8.1	-0.6	-29.3
42	Manufactures n.e.c.	24.7	22.7	64.3	-45.1
	Total	15.6	19.0		

[a] ERP has not been defined since value added at world prices was negative.
Sources: Centre for International Economics, *Vietnam's Tariff Schedule* (1998a); GTAP4 database

The ERPs for Vietnamese industries have been calculated using input-output table information from the GTAP Version 4 database. Table 6 reveals very high effective rates of assistance for import substitution activities in industries such as apparel, motor vehicles and parts, and textiles. These distortions provide strong incentives for firms to engage in production only for the domestic market, and to draw resources away from firms able to compete on world markets.

The fourth column of Table 6 shows the effective rate of protection applying to a firm that produces for the export market, but is unable to benefit from exemptions of import duties on imported inputs. As expected, the effect of the tariff regime on such a firm is invariably negative, because the cost-increasing effects of higher prices for intermediate goods are not offset by benefits on output prices[7]. It is worth noting that the

[7] Negative effective rates of protection may clearly exceed 100 percent, but production for export is unlikely to take place in this situation.

negative effects for exporters are the largest for such industries as apparel and motor vehicles where the prices of intermediate inputs, as well as outputs, are raised by protection. This is at least partly because the government tends to use tariff and other protective measures on intermediate goods to achieve localization objectives (see Box 1).[8]

Two cautions should be borne in mind in interpreting these protection figures. First, these figures do not include the protective effects of Non Tariff Barriers (NTBs). A set of important industries, including cement, steel, sugar and paper industries, is protected by quantitative restrictions rather than tariffs. Second, the ERP for export production does not include the firms who benefit from the duty-draw back system.

Non Tariff Measures (NTMs)

A complex set of non-tariff measures remains in Vietnam. Quantitative restrictions are used to "regulate supply and demand" and to protect the domestic production of "potential" and "infant" industries (WTO, 1998). The regulations on import quota and the list of prohibited imports/exports appear to change from time to time, creating considerable uncertainty for traders. Products subject to import licensing restrictions fall into three main groups: goods subject to import licensing and quotas under Decree 57 and Decision 254; goods subject to specialized management by line ministries; and goods banned from imports. These import licensing restrictions currently cover approximately 40 percent of imports (World Bank, 1999b). Ten types of imports are subject to licensing under Decree 57, including petroleum and oil, fertilizer, motor cycles, cars of 15 seats or less, steel and iron, cement, sugar, paper, alcohol, and construction glass. Imports of some of these products are occasionally banned (IMF, 1999b).

[8] For production and assembly of electronic appliances, the localization ratio is at least 20 percent for the first 2 years and must be increased annually; for production and assembly of automobiles, the required localization ratio is 5 percent after the first 5 years and must be increased to reach 30 percent after the first 10 years; for motorcycles and spare parts, the required localization ratio is 5-10 percent after the first 2 years and must be increased to 60 percent after the first 5 years (WTO, 1998).

Formal access to foreign exchange is still subject to considerable restrictions, although the multiple exchange rate regime that prevailed prior to 1989 has been unified. Foreign invested entities are generally responsible for balancing their own foreign exchange requirements. Only entities involved in projects producing specific import substitutes, specified infrastructure projects and designated important projects are guaranteed conversion of local currency.

Trade Reform in the Lao PDR

The adoption of the New Economic Mechanism (NEM) in 1986 signaled a significant shift of the Lao PDR's economy from a centrally planned system to a market system. Since then, public enterprises have been given operating autonomy, and the private sector has been authorized to participate in economic activities. In 1987, the Lao PDR abolished the practice of "cost plus" pricing for state enterprises in favor of market-determined prices. In 1988, the Lao PDR abandoned the multiple exchange rate system and moved to a single rate close to that previously prevailing in the parallel market.

Trade liberalization has been one of the pillars of the economic reforms; under the NEM, the state monopoly on trade in most goods has been eliminated, tariff rates have been lowered and quantitative restrictions and specific licensing requirements have been reduced. In the meantime, the end of the Cold War eased the political tension between the Lao PDR and its Southeast Asian neighbors. The collapse of the former Soviet Union and other former Council for Mutual Economic Assistance (CMEA) countries led to a substantial shift in the Lao PDR's direction of trade from the nonconvertible to the convertible currency area and especially towards the ASEAN countries. Throughout the period, the approach of the Lao PDR's economic reforms has been "gradual" rather than "big bang." However, the Lao PDR's reform efforts have slowed or even reversed in some areas in the recent years, especially after the regional financial crisis.

Protection on Imports

Table 7 shows the Lao PDR's statutory tariff structure. The current tariff rates range from 5 percent to 40 percent with 6 tariff bands (5, 10, 15, 20, 30, 40).

Table 7. The Lao PDR's Statutory Tariff Rates

Tariff Rates	*Tariff Line*	*Share (%)*
5	1820	51.3
10	1151	32.4
15	7	0.2
20	246	6.9
30	201	5.7
40	123	3.5
Prohibited	3	0.1
Total	3551	100

Source: Customs Department, Vientiane

Overall, the Lao PDR's tariff rates imply a relatively low level of protection for a low income country, with a simple average of 9.6 percent and a weighted average of 14.7 percent. Effective May 10, 1997, the tariff rates for some "luxury" commodities which had been above 40 percent,[9] were reduced down to a maximum 40 percent with the duties above 40 percent being replaced by excise taxes (Government of the Lao PDR, May, 1997). Tariffs subject to the reform included 41 tariff lines covering motor vehicles, motorcycles, beer, tobacco, and household appliances.

Table 8 shows the differences in the tariff rates weighted by the Lao PDR's imports sourced from ASEAN and the rest of the world. While the tariff rates are the same at the tariff-line level, the weighted averages differ because of differences in the mix of imports in each group. Average tariffs differ slightly between ASEAN and the rest of the world, with duties on imports from ASEAN averaging 15.2 percent as against 13.4 percent from the rest of the world. The weighted average tariff rates for *animal and animal products*, *vegetable products* and *processed foods, drinks & tobacco* are

[9] Before the reform, the higher rates were applied to cigarettes (60 percent), beer (80 percent), and vehicles (up to 150 percent.)

considerably higher for imports from the rest of the world. Conversely, ASEAN partners face a substantially higher tariff than the rest of the world for *transport equipment*.

Table 8 Statutory MFN tariff rates applying to imports from ASEAN and ROW

Description	*Total*	*ASEAN*	*ROW*
	%	%	%
Animals & animal products	7.1	6.8	17.6
Vegetable products	13.0	9.5	19.4
Animal & Vegetable oils	10.1	10.1	10.0
Processed foods, drinks & tobacco	30.7	29.1	37.6
Oil and minerals products	5.0	5.0	5.9
Chemical products	10.5	11.2	8.3
Plastic & rubber products	12.1	12.2	11.2
Skins & furs and their products	13.7	13.5	14.1
Wood & wood products	31.0	31.1	29.6
Pulp of wood & paper	8.8	9.0	7.1
Textiles	9.5	9.5	9.9
Apparel	10.3	10.2	10.9
Shoes, hats, umbrellas, etc.	10.1	10.1	10.1
Stone, ceramic & glass products	5.2	5.1	6.8
Jewelry & precious metal products	5.0	5.0	5.0
Base metals & their products	5.9	6.0	5.3
Electrical & mechanical equipment	7.7	8.8	5.9
Transport equipment	26.9	32.7	17.9
Photographic, optical, precision instruments	6.0	6.4	5.6
Arms & munitions	30.0	n.a.	30.0
Miscellaneous articles	13.2	13.9	11.4
Objets d'art	5.0	5.0	5.0
Total	14.7	15.2	13.4

Statutory tariff rates, however, are not indicative of actual tariff collections since there are exemptions to the tariffs. The special privileges granted for foreign firms are the most important source of tariff exemptions. Foreign investors are required to pay import duties for the importation of production equipment and facilities, spare parts and other equipment used in the project or business operations at the rate of 1 percent of the imported value. Raw materials and intermediate components imported for export processing are exempt from import duties. Raw materials and intermediate components imported for the purpose of achieving import substitution are also eligible for special duty reductions. In addition, some companies can obtain a "convention" that clears them to import or export specified products free of all taxes (Finger and Castro, 1997). *Ad hoc* tariff exemptions are often granted, principally for imports by state enterprises. The use of appreciated exchange rates for customs valuation purposes has been another source of shortfalls in import duty collections. In 1998/99, a rate of 4,000 kip per dollar was used for import valuation while the commercial bank rate averaged 6,345 kip per dollar.

In the Lao PDR, non-tariff barriers are less transparent and more difficult to quantify than in many other countries. While many of these barriers are not atypical in developing countries, some appear influenced by the form of the trade regime under the planning system. The Prime Minister's Order 06/PM of March 1999 reduced the number of licensed trading companies by forming six trading groups. Each importer is licensed to import no more than the allocated quantity and individual shipments need to be licensed by the Ministry of Commerce and Transport (IMF, 1999a). Quotas apply to the importation of fuel and lubricants, steel bars for construction, all types of cement, and all types of motor vehicles and motor cycles. The authorities continue to use administrative measures to allocate foreign exchange. Traders also report that customs clearance procedures are slow, and that the licensing system is inefficient.

The transportation oligopoly that governs transit trade through Thailand remains a serious non-tariff barrier on Lao PDR exports. According to Finger and Castro (1997), T-L Enterprise had a monopoly of transit shipments across Thailand to and from the Lao PDR until 1994, and remains the only agent authorized to officially process shipments into and out of the Lao PDR through Thailand. The transport markup is reported to be at least 20 percent, making the cost of shipment from the Lao PDR to Bangkok as large as the cost from Bangkok to Europe. These high transit costs place strong downward pressure on returns to labor and capital, which are already disadvantaged by relatively high transport costs. For the economy as a whole, the excess transportation cost is worse than a tariff because much of the excess cost likely accrues to foreigners.

Trade Reform in Cambodia

Since the formation of the Royal Government in 1993, the reform of Cambodia's trade regime from a centrally controlled system into a relatively open system has been impressive. The government's objectives have aimed to foster Cambodia's integration into the world economy. Key steps were taken very rapidly, particularly during the transition and early phases of the establishment of the Royal Government. Important early reforms included the unification of exchange rates, tariff reform, the abolition of many nontariff barriers, and the implementation of a liberal Law on Investment. Perhaps because of the difficulties faced by the new government, in the context of ongoing rebellion by the Khmer Rouge, the transition was much more abrupt than in China, Vietnam or the Lao PDR.

Trade reform involves particularly important transition issues for Cambodia given its current heavy reliance on tariff revenues. In 1998, trade tax revenues represented 56 percent of Cambodia's total tax revenues. This dependence constrains the scope for trade reform, and makes complementary tax reforms a key priority. A high proportion of tariff revenues is earned on a small number of high-tariff products such as petroleum and cigarettes. Converting these tariffs to excise duties would allow more revenue to be raised for any given rates in those cases where domestic production exists, and remove the artificial incentives for import-substituting local production. As can be seen from Table 9, Cambodia's tariff regime has reasonably low tariffs on average, although there is considerable variation between products.

An important feature of Cambodia's transition strategy is a very liberal investment regime designed to attract foreign investment. This regime includes liberal exemptions on investment goods and inputs used in the production of exports, as well as income tax concessions (Martin 1996). It has certainly been successful in attracting investment in areas such as clothing,

Table 9 MFN Tariff Rates for Cambodia		
Description	*Simple Average(%)*	*Weighted Average(%)*
Animals & animal products	25.4	15.9
Vegetable products	13.2	9.0
Animal & Vegetable oils	7.6	7.0
Processed foods, drinks & tobacco	25.8	15.4
Oil and minerals products	14.0	23.9
Chemical products	11.2	5.3
Plastic & rubber products	10.7	10.7
Skins & furs and their products	29.8	31.7
Wood & wood products	31.7	33.1
Pulp of wood & paper	7.0	7.0
Textiles	19.4	20.1
Apparel	27.9	20.1
Shoes, hats, umbrellas, etc.	27.4	29.4
Stone, ceramic & glass products	12.5	8.1
Jewelry & precious metal products	35.9	0.4
Base metals & their products	14.5	9.0
Electrical & mechanical equipment	17.0	15.1
Transport equipment	29.3	24.2
Photographic, optical, precision instruments	13.0	10.8
Arms & munitions	40.0	38.0
Miscellaneous articles	17.9	13.7
Objets d'art	n.a.	n.a.
Average	16.6	17.3

In Cambodia, as in Vietnam and Lao PDR, the stimulus for a great deal of recent modernization of trade procedures and for preferential liberalization of trade barriers has been accession to the ASEAN Free Trade Area. In the next section, we turn to the use that transition economies can make of regional and global trade arrangements in their reform efforts.

The Role of Regional and Multilateral Trade Agreements

While the advantages of an open trade regime are widely recognized by policy makers, it remains difficult to build political support for such a regime in the face of pressures from vested interests. Participation in regional arrangements may help to build support for liberalization (World Bank 2000). Such participation may also be very useful in obtaining the policy credibility that is needed to attract long term, irreversible investments in export production, or other activities that require a consistent policy regime.

It appears that accession to the ASEAN Free Trade Area has been a useful initial step for the new ASEAN members of Cambodia, Laos, Myanmar and Vietnam (Martin and Fukase 2000). Meeting the requirements of accession has helped countries modernize their procedures, and required them to make sweeping liberalization commitments on most of their imports. Some of the exceptions allowed under the original liberalization commitments have been excessive, but there appears to be a strong policy dynamic within ASEAN that reduces these exceptions over time.

It is important that participation in regional arrangements continue to be seen as a stepping stone, rather than a stumbling block, on the path to a more open trade regime. The big problem with regional trade liberalization is that it introduces costly trade diversion in addition to the healthy trade creation that is its most immediately apparent effect. This problem of trade diversion is particularly serious if the external trade barriers in the bloc are high. Even in ASEAN where, as we have seen, external trade barriers are relatively low, the welfare gains from trade creation are, in most cases, almost completely wiped out by the losses from trade diversion for the new members of ASEAN (Fukase and Martin 2000).

Accession to the WTO is one approach to further deepening reforms. WTO members now require quite stringent liberalization commitments from new WTO members. New members are, for instance, likely to be required to bring average tariffs to 10 percent or less, and to enter into a very wide range of commitments, both on trade in goods and in a wide range of other areas including the protection of intellectual property, and trade in services. Since crucial rules, and particularly the reliance on price-based measures of protection, are critically dependent on a market-oriented economic system, accession is likely to impose strong constraints on state activity in the economy. A particularly important commitment on trade in goods is the phase-out of quantitative trade measures. While these commitments may be politically difficult, such nondiscriminatory liberalization commitments will almost always generate much larger gains than those available from regional arrangements (See Fukase and Martin 2000 for examples from ASEAN; Ianchovichina, Martin and Fukase 2000 for examples from China).

WTO membership has a powerful mechanism for increasing the credibility of commitments to a generally open trade regime. Once tariffs are bound at a low level, it is difficult for them to be increased, a constraint that can be very helpful in maintaining an open trade regime in the face of pressures from special interests within the country for increases in the tariffs of particular interest to them.

WTO membership also provides governments with important protection from larger trading partners (Michalopoulos 1998). Of particular interest to East Asian exporters is the obligation under the Uruguay Round Agreement on Textiles and Clothing to phase out quotas on textiles and clothing by 2005. It also provides protection against unilateral pressures to meet unilaterally-declared and enforced standards on products or processes. The WTO dispute settlement mechanism has proved very useful in protecting the interests of small trading countries.

The accession process can be long and difficult, although countries that are prepared to meet the high standards required by members of the Working Parties on Accession can accede relatively quickly, as has been demonstrated by the rapid increase in the membership of WTO in recent years. The East Asian transition economies whose average tariffs are in the 10-20 percent range are in striking distance of the tariff rates they are likely to need for WTO accession—although substantial further changes are likely to be required.

Conclusions

The performance of the East Asian transition economies during the 1990s has clearly been remarkable relative to that of the transition economies of Central Europe and the former Soviet Union. The East Asian economies have been able to achieve remarkably high rates of growth in both exports and output during this period, without the frequently large declines in output and exports observed in Europe and the FSU.

The transition process from a planned economy to an open, market-oriented economy requires a large number of inter-related changes. Domestic reforms are needed to define property rights, to make enterprises competitive, and to ensure that they respond to price incentives. In the trade policy sphere, inter-related reforms are needed to: open up the trade system to competing traders; to develop indirect policy instruments such as tariffs; and to remove exchange rate distortions. While these reforms are difficult, each of the East Asian transition economies with a sustained commitment to reform[10] has managed to make these reforms in its own way, and to great effect during the 1990s.

The trade regimes in all of these countries have a considerable distance to go, not only in terms of reducing barriers, but also in terms of developing systems that will facilitate trade flows and create a more predictable and sustainable investment climate. However, many of the most difficult steps have been taken in terms of developing domestic institutions, and modernizing the trade regime. Most of the problems that remain in these countries are similar to those faced by other, non-transition, economies. The experience of the East Asian transition economies should provide a great deal of reassurance both to policy makers in other countries contemplating entering the reform path, and to policy makers in the transition economies themselves.

[10] Clearly, this group includes China, Cambodia, Lao PDR, and Vietnam

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